

What Went Wrong With Kmart?

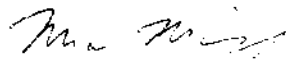
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Table of Contents

Abstract.....	3
Introduction.....	4
History of Kmart.....	4
Overview of Kmart.....	6
Kmart's Problems That Led to Bankruptcy.....	6
Major Troubles in 2001.....	7
2002 and Bankruptcy.....	9
Anonymous Letters Lead to Stewardship Review.....	9
Emergence from Bankruptcy.....	12
Charles Conaway's Role.....	14
The Case Against Enio Montini and Joseph Hofmeister.....	17
Conclusion.....	19
Works Cited.....	20

Abstract

This paper provides an in depth look at Kmart Corporation. I will discuss how the company began its operations as a small five and dime store in Michigan and grew into one of the nation's largest retailers. Kmart is a store that strives to meet its customers' expectations of low prices and good quality merchandise. I will talk about how Kmart achieves this and how well it is working.

Kmart has encountered many problems in the past few years. I will talk about the problems that led to the 2002 declaration of bankruptcy as well as how the company was able to emerge out of bankruptcy. A stewardship review was conducted to find any wrongdoings that were going on inside Kmart. The review revealed many surprising items and each of them are discussed in great detail. Kmart has undergone many changes in its management due to corrupt practices by previous management. These practices will be discussed in detail. Also, two former executives have been formally charged with fraud and detail will be given about these charges.

Introduction

Kmart is a mass merchandising company which serves customers in the United States, Puerto Rico, and the Virgin Islands through its 1,512 retail stores (Kmart Corporate). Kmart has for years been trying to compete with similar discount retail stores, such as Wal-Mart and Target. The company had been struggling for years, when on January 22, 2002, it filed for Chapter 11 bankruptcy. Poor sales and bad decisions by top executives are mostly to blame for the bankruptcy declaration. In 2003, Kmart emerged from bankruptcy and its stock started to sell on NASDAQ. This paper will discuss the history of Kmart, a brief overview of the company, the company's problems which led to bankruptcy, Kmart's emergence from Chapter 11 bankruptcy, and the roles many executives played in the downfall of the company.

History of Kmart

In 1899, Sebastian Spering Kresge opened a five-and-dime store which would be the precursor for one of the biggest retailing chains in the country. S.S. Kresge Company opened in downtown Detroit and sold everything for five and ten cents. The low prices appealed to customers and by 1912 Kresge had opened 85 stores and had annual sales of over \$10 million (Kmart Corporate). Kresge's operations continued through America's depression with a goal in mind. He strived to maintain the low prices his stores had always offered and continued to provide jobs to people.

Under the reigns of new Kresge president Harry B. Cunningham, the first Kmart discount store opened in 1962 in Garden City, Michigan. Another seventeen Kmart stores were opened in the same year and sales amounted to \$483 million that year. By

the year 1977, about 95% of S.S. Kresge Company revenues were generated by the more than 1,200 Kmart stores. Later the same year, the company officially changed its name to Kmart Corporation and eventually sold all remaining Kresge stores. Kmart Corporation was now running a whole-hearted discount chain and that's where its focus would lie for the next thirty years (Kmart Corporate).

Beginning in about 1984, Kmart Corporation attempted to expand its operations. Kmart acquired Walden Book Company and Builders Square in 1984 and in the early nineties purchased The Sports Authority and Borders, Inc. Kmart also acquired a 90 percent interest in OfficeMax at this time. The attempt to expand operations was short lived however because in 1994 Kmart announced its intent to make Initial Public Offerings (IPOs) of its interests in The Sports Authority, OfficeMax, and Borders, Inc. Shortly after, Kmart sold its Builders Square operation to Kmart Canada (Kmart Corporate). This attempt to broaden Kmart's horizons may be, in part, what went wrong with the company. The company's operations were not diversified anymore. Kmart was competing solely in the discount merchandising arena.

Kmart tried another strategy to try to gain more of the market share. In 1985, Kmart began a line of clothing using Jaclyn Smith's name to sell the clothing. Kmart continued with this strategy by using such names as Martha Stewart and Kathy Ireland. The Martha Stewart line proved to be a huge success from its initial debut in 1997 which featured a line of bed and bath fashions and accessories. Other items have been added to the Martha Stewart line including: garden and patio products, baby products for the nursery, a garden collection, a line of housewares essentials, an assortment of storage and organizational products, and home decorating products. Kmart continues to use and have

success with the Martha Stewart lines despite of the recent trouble she's been in. Kmart also has long-term licensing agreements with Joe Boxer and Disney to sell their products (Kmart Corporate).

Overview of Kmart

Kmart is a discount retailer that serves its customers by offering quality goods at affordable prices. Kmart strives to offer a number of different types of stores to its consumers. The three types of stores are Big Kmart, Kmart Super Center, and the traditional Kmart Store. By offering such an array of products at each of these stores, Kmart can reach a diverse client base.

The Kmart Super Center, for example, is a mix of the traditional discount store and a full size grocery store. These also typically offer a pharmacy and operate 24 hours a day. I think Kmart really provides its customers with a great variety of ways to shop. The average consumer can choose to go to Kmart to go grocery shopping and get other various household items instead of having to go to numerous stores.

Kmart's Problems That Led to Bankruptcy

Prior to Kmart's January, 2002 declaration of bankruptcy, the company had been facing many problems. The problems stemmed back to 2000 when Charles Conaway was named the new Chief Executive Officer (CEO) and elected Chairman of the Board of Directors (BOD). In 2000, Kmart received many complaints about dirty, cluttered stores that were frequently out of items that should have been in stock. Customer service was also a major complaint at this time.

In 2000 while Kmart struggled, other discount retailers such as Wal-Mart and Target flourished. Kmart lacked a good advertising campaign to lure customers away from these fierce competitors. Another problem that Kmart faced was an inefficient inventory distribution system. Wal-Mart has been so successful because of its state of the art inventory system and Kmart tried to duplicate this—it didn't work. Kmart ended up with high levels of inventory and no efficient way to distribute this inventory. The combination of all these problems would prove to be part of the downfall of Kmart.

Major Troubles in 2001

The year 2001 proved to be the year that broke Kmart. The new management, under Conaway, had been fully implemented and the problems just kept coming. These problems included improper hiring procedures, inappropriate use of the company's plane policy and the program known as "BlueLight Always."

Under new CEO Conaway, the company's management began to hire employees without following any of the traditional hiring procedures. Prospective hires were not required to fill out full applications and background checks were not performed on them. Kmart's management did not consent with the Human Resources department before hiring any managers. Managers were hired without being interviewed and were given excessive compensation packages that were bigger than any employees had ever received. These new hires quickly proved to be unqualified and soon left their jobs or were terminated (Dybis "Frat Boys").

Another problem in 2001 was the inappropriate use of Kmart's aircraft fleet. Managers spent about \$12 million on new corporate airplanes without ever seeking

proper authorization for such an expenditure. As it turns out, that money was never set aside for the purchase of airplanes. Executives were allowed to use the planes to visit stores, but they also used the planes for personal use. To hide the fact that they were on a personal trip, the executives would fill the plane with Kmart employees and make it appear as if it were a business trip (Dybis "Frat Boys"). It appears as if their internal control system was weak. A properly functioning internal control system would not allow \$12 million dollars to be spent without some type of authorization.

In the summer of 2001, Kmart launched a new program called, "BlueLight Always." This proved to be the biggest mistake of the year. This program included a huge inventory push. About \$850 million in merchandise was bought in an attempt to lower prices and launch an all-out pricing war against Wal-Mart. In much the same way the planes were purchased without proper authorization, this huge amount of inventory was also purchased without talking to the treasury officials about whether Kmart had enough money to support the purchase. Kmart did not consult its suppliers to see if the program would be viable and failed to consider if the company could even support such an aggressive program.

"BlueLight Always" failed and cost Kmart millions on new store signs, advertising, and leftover merchandise. During this time Kmart claimed to have lower prices than competitor Target and this resulted in the threat of a lawsuit (Dybis "Frat Boys"). The failed program caused a liquidity crisis at Kmart because they had spent so much money on inventory. At this point, any small incident involving a need for cash flow would send Kmart directly to bankruptcy.

2002 and Bankruptcy

In the week before the declaration of bankruptcy, Kmart's main food and consumables distributor, Fleming Companies Inc., announced its plans to halt shipments to Kmart. Just a week before Kmart filed for bankruptcy, Fleming announced it stopped shipping goods because Kmart missed a regularly scheduled payment. At that time, Fleming said it would like to continue the relationship with Kmart once they are able to resume regular payments (Fleming).

On January 22, 2002 the inevitable happened—Kmart filed for reorganization under Chapter 11 of the U.S. Bankruptcy Code. At this time Kmart announced the closing of 283 stores. Eventually Kmart would be forced to close more than 600 stores with the elimination of about 67,000 jobs (Kmart Corporate). One response Kmart had to the bankruptcy was to cut down its senior-level management team. A dozen or so jobs were cut at company headquarters in Troy, Michigan in May 2002. Among the employees that were let go are Enio Montini and Joseph Hofmeister, both of whom have been charged with securities fraud among other things. A discussion of these men and the charges against them will follow later.

Anonymous Letters Lead to Stewardship Review

Throughout 2002, Kmart claims to have received about 65 anonymous letters that claim to be from employees. The letters allege wrongdoing by former managers. In response to the letters, Kmart launched a full review of its accounting practices late in 2002. A stewardship review was conducted and the report issued in January, 2003. One of the major issues the review addressed is the millions of dollars in loans given to top

executives in 2001 before the declaration of bankruptcy. Accounting irregularities and other problems were also found.

The stewardship review was conducted by Kmart's bankruptcy counsel, the Chicago law firm Skadden, Arps, Slate, Meagher & Flom and two forensic accounting firms. In conducting the investigation more than 570 people were interviewed. About 1.5 million pages of documents were reviewed including accounting records, e-mails, and auditing papers. Following are the conclusions from the stewardship review.

The financial statements were wrong for the periods 1999-2001 and the first two quarters of 2002. The review caused Kmart to restate the financial results for these periods. Included in these periods are \$92 million in questionable vendor transactions.

Another issue addressed in the review is the controversial retention loan program Kmart has. During 2001, Kmart's top executives asked the BOD for additional bonus money. Because the financial statements were wrong, they looked good to the board and the bonuses were granted. However, the bonuses, or retention loans, were not given out as the board intended. The stewardship review states, "In addition management created purported committee documents that varied materially from the loan program documents submitted (to the board) for approval, and these documents were inserted in the company's official board files after the fact" (Dybis "Frat Boys"). Kmart's BOD is not to blame, but the executives are. The board approved what looked to be reasonable bonuses based on the financial statements that were presented to them. The statements were wrong and the bonuses were not even handed out in accordance with the agreement.

Kmart is not the only company to come under fire for handing out loans to its top executives. WorldCom, Tyco International Ltd., and Adelphia Communications Corp.

have also been under close scrutiny for handing out loans to top officials. All the employees who received loans out of this program at Kmart have either left the company or have since been fired. Kmart's stewardship review uncovered evidence that supports the firings of ten former executives "for cause." Among these ten people are the former president, Mark Schwartz, and the former chief financial officer (Kaiser and Cohen). Interestingly, former CEO Charles Conaway was not one of the ten mentioned. His role in the downfall of Kmart will be discussed later.

The review uncovered that many vendor allowances were improperly accounted for. A vendor allowance is the money that a supplier might give Kmart in exchange for an advantage, such as better shelf space. Kmart juggled these allowances and ignored the established rules the company had for accounting for them. The allowances were moved to the wrong time periods to cover up cash flow problems. At the same point in time, Kmart executives began to force employees to adopt outrageous practices and policies. Employees were expected to meet unattainable goals in order to produce acceptable financial reports for top management. If an employee resisted, he or she was demoted or transferred to another department.

"Project Slow It Down" was initiated in September, 2001 (Dybis "Frat Boys"). Under this program, executives slowed or sometimes stopped payments to vendors in an effort to cover up liquidity problems. When the suppliers questioned Kmart managers, they were given deceptive answers.

The anonymous letters allegedly sent from Kmart employees have proven to be the cause of the stewardship review. In response to this, the U.S. Securities and Exchange Commission (SEC), the Federal Bureau of Investigation (FBI), and the House

of Representatives Energy and Commerce Committee have also launched similar investigations. The letters obviously have truth to them as all of these problems have surfaced since the investigation started.

Emergence from Bankruptcy

On May 6, 2003, Kmart emerged from Chapter 11 bankruptcy by completing a fast-track reorganization plan (Kmart Corporate). The U.S. Bankruptcy Court in Chicago approved Kmart's reorganization plan in late April. The emergence from bankruptcy means a lot of changes have taken place or will take place at the company. It is currently unknown if Kmart will be able to fully bounce back from the troubles it had in the past, but they are trying their best. A major strength Kmart gained is a \$2 billion dollar loan which will enable the company to compete against its major competitors, Wal-Mart and Target.

During the reorganization process, Kmart placed major emphasis on closing unprofitable stores and focusing on those that were most productive. According to the Kmart Corporate website, many new initiatives were implemented including the following:

- Improving store operations and inventory management;
- Pursuing opportunities to reduce annual expenses through reengineering the organization, making necessary staff reductions, consolidating the distribution network and other related actions;

- Introducing a number of new exclusive national brands, including Disney and JOE BOXER, and expanding relationships with existing brand partners, highlighted by the Martha Stewart Everyday Holiday line; and
- Expanding and redesigning weekly advertising circulars and implementing a strategic marketing plan aimed at Hispanics and African Americans, who collectively comprise one of the fastest-growing customer segments.

It is obvious that Kmart addressed many issues that were to blame for the bankruptcy. Inventory was a huge problem that Kmart just couldn't seem to get right. This was a crucial element of success because Wal-Mart's inventory system was nearly perfect. Also, the relationships Kmart had with companies such as Martha Stewart Living, Joe Boxer, and Disney are important to the success of Kmart. Kmart has exclusive rights to these products that their competitors don't have. It is important that they continue to nurture these relationships.

Kmart believes that it has successfully completed all it needed to during the Chapter 11 bankruptcy process. They have strengthened their balance sheet by getting rid of much debt, developed a more cost-efficient organization, and obtained \$2 billion in exit financing (Kmart Corporate).

Looking to the future, Kmart has developed many priorities and strategies that it believes will contribute to its success. Kmart has, "A renewed focus on our stores and in helping them enhance our customers' shopping experiences," (Kmart Corporate). As I discussed earlier, one of the main complaints customers had about the stores was the

messy and cluttered appearance. Management has listened to this complaint and is addressing it so customers may have a more enjoyable shopping experience.

In the restructuring process, Kmart has also delegated responsibility differently than it did in the past. For example, in the past about 220 managers had the authority to approve final supplier orders- this number is down to fifteen (“Kmart Comes Out”). Kmart has also decided to give more authority to each store’s individual manager about what the store should carry. I think this is a huge step because every store will be different in terms of what customers want to buy. Buying patterns are different as you move across the country to the different regions. The corporate headquarters would only be guessing about which products would be successful at a given store. The store manager is now empowered to help their own store be profitable.

Another major change that came out of the reorganization process was the creation of Kmart Holding Corporation. Kmart Corporation will now be an indirect subsidiary of Kmart Holding Corporation. The stock of the holding company has been issued and is currently trading.

After all is said and done, Kmart currently operates more than 1,500 stores in the United States, the Caribbean, and Guam. Kmart has taken a modest approach toward growth as no new stores are currently planned for the year 2003.

Charles Conaway’s Role

In May, 2000, Kmart named Charles Conaway as its new CEO and chairman of the board. He was to take the helm from current president Floyd Hall. Under Hall, Kmart achieved great successes. He helped a struggling retailer make a name for itself

once again. Under Hall, the company closed unprofitable stores, sold many of its foreign assets, and converted many regular stores to Big Kmart, stores which feature a small grocery section. During Hall's reign, Kmart also introduced brands such as Martha Stewart Everyday. He is credited with saving Kmart from losing to its biggest competitors. When Hall announced in 2000 that he planned on retiring within a year, Kmart tapped CVS executive Charles Conaway for the position.

Conaway was the president and chief operating officer (COO) at CVS, the nation's largest drugstore chain. This title gave him the responsibility for all merchandising, advertising, store operations, logistics, and e-commerce. Conaway held many positions in the company's pharmacy division from 1992-1996. In 1996, he was named chief financial officer and held that position until 1999 when he was named president and COO. Under Conaway, CVS developed its Internet strategy. Conaway also oversaw the inventory distribution system— an area Kmart desperately needed help in (Marino-Nachison).

When Conaway was named new president, analysts noted one shortcoming of his past experiences; he had no experience in fashion. Kmart had previously struggled in their fashion department. Many of their competitors offer trendier items, so Kmart had to find a way to better promote their fashion line. Conaway also had to find a way to keep the current executive management team in place once he took over. Two qualified Kmart executives were overlooked for the job, so it remained to be unknown how that relationship would play out.

During Conaway's short reign at Kmart, his most notable achievement was the revival of Kmart's ever famous "Blue Light Special." With the successful return of this

program, Kmart introduced a new program called “BlueLight Always.” This turned out to be a disaster and left Kmart with millions of dollars of merchandise that could not be sold.

In March, 2002, Conaway announced he was leaving Kmart to spend more time with his family. He said he had been thinking about leaving for some time and decided it was a good time for him to leave. His departure came only weeks after Kmart declared bankruptcy in 2002.

In May, 2001, only ten months before his departure, Conaway received a \$5 million cash loan and a performance option grant in return for a commitment to stay with Kmart. Ten months later he left, the \$5 million dollar loan was forgiven, and he also received a \$4 million severance payment (Kaiser and Cohen). This raised many red flags in people’s minds, especially the employees, because if Kmart had declared bankruptcy only weeks before, how could they afford to give him such gross amounts of money. However, Conaway was not the only one to receive huge sums of money during Kmart’s hard times. Just before the end of 2001, he permitted other executives to receive almost \$24 million in retention loans and other payments.

In the year following Conaway’s departure, an investigation was launched to determine if former managers should be held accountable for Kmart’s downfall. In early 2003, Kmart’s board announced it had evidence that would support a lawsuit against Conaway. The board says that Conaway failed to disclose the company’s liquidity problems and he failed to properly supervise the company’s employees that were directly or indirectly under him. The board also claims Conaway knowingly took part in a program that toyed with vendor payments, either partially paying them or not paying

them at all. If Conaway had properly presented the company's financial position, the board claims the retention loans Conaway authorized would never have been given out.

Another question being raised by the board is if Conaway should have been fired "for cause." If this is the case, Conaway may be held responsible for paying back the \$4 million in severance pay and the \$5 million loan that was forgiven. The problem that is holding up the investigation is the wording of Conaway's contract. It gives very definitive terms that would constitute firing. According to the contract, he can only be fired if he commits a felony or if his acts of neglect or misconduct cause material hardship to the company.

Conaway was tapped to be the young savior of Kmart. He was supposed to continue the great successes Floyd Hall had with the company and make it into the profitable company it had once been. Instead, Kmart took a turn for the worse and filed for Chapter 11 bankruptcy under Conaway.

The Case Against Enio Montini and Joseph Hofmeister

During the investigation into whether Kmart's former managers should be held accountable for the company's downfall, evidence surfaced to support a lawsuit against two former vice presidents. Enio Montini and Joseph Hofmeister were both formally charged with securities fraud, making false statements to the SEC, and conspiracy to commit these offenses on February 26, 2003 (Ex-Kmart Execs). Montini was a former senior vice president and general merchandise manager and Hofmeister was a former divisional vice president of merchandising. If charged, the two could face up to ten years

in prison for the fraud charge, another five years for lying to the SEC, and could face a fine for the conspiracy allegation.

These charges stem from a \$42.3 million vendor payment from American Greetings. The money was subject to repayment under certain circumstances, but it was fully booked by Kmart in the second quarter of 2001. This caused Kmart's operating income to be overstated by \$42.3 million for that period. In addition, this helped Kmart meet Wall Street's earnings expectations for that period. Kmart understated losses for that period by \$0.06 per share (Ex-Kmart Execs). This is a huge deal to investors. If a stock misses earnings expectations by just one cent it can cause the value of the stock to drop drastically. As a result of Montini and Hofmeister's wrongdoings, stockholders were greatly misled.

The SEC is also filing a civil suit against the two former executives. They are seeking return of financial gains relating to their wrongdoings. In addition, the SEC is investigating a retention loan in the amount of \$750,000 that Montini received from Kmart. The SEC wants to bar the two from ever being able to serve as officers or directors for any publicly traded companies.

Both men were let go by Kmart in May 2002 when about a dozen jobs were cut at company headquarters in Troy, Michigan. If convicted of these charges, both men will face the serious consequences of their actions.

Conclusion

Kmart is a company that has overcome many obstacles in its long history. S. S. Kresge started it out as a small five and dime company in Michigan and it has grown to

one of the largest discount retailers in the country. Kmart has been the underdog for a long time behind fierce competitors Wal-Mart and Target. With a new management team in tow and a bankruptcy behind it, the future remains unknown for Kmart. To be successful, the company must correct all the internal problems that led to bankruptcy. If Kmart can overcome this, I think the future looks bright for this company.

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